

Effective Date: June 26, 1995

**COORDINATED ISSUE  
All INDUSTRIES  
DOLLAR-VALUE LIFO  
SEGMENT OF INVENTORY EXCLUDED FROM  
THE COMPUTATION OF THE LIFO INDEX**

**ISSUE**

Whether a LIFO index developed by double-extending one segment of the inventory can be applied to another segment of the inventory that was not double-extended.

**FACTS**

The regulations allow a taxpayer to compute an index by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. Many taxpayers attempt to shortcut the requirements of the regulations. This is attempted by: double-extending only the large dollar items in the inventory and applying the derived index to the entire inventory; using samples that are not statistically valid and applying the derived index to the population; not including new items in the computation of their index and applying the index to the entire inventory including new items; and determining an index for one segment of the inventory (a warehouse for example) and applying that index to other segments of the inventory (its stores for example). Because each of these methods involve the same fundamental question, they have been combined into one coordinated issue.

**LAW**

Section 472(a) of the Internal Revenue Code allows a taxpayer to elect the LIFO inventory method. The use of LIFO, however, must be in accordance with the regulations, must be applied on a consistent basis, and must clearly reflect income. In addition, inventories on LIFO must not be valued lower than cost.

Treas. Reg. Sec. 1.472-3(d) states "Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns."

Treas. Reg. Sec. 1.472-4 states that "(a) taxpayer may not change to the LIFO method

of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved."

Treas. Reg. Sec. 1.472-8 prescribes the operating rules for the use of the dollar-value method of pricing LIFO inventories. Treas. Reg. Sec. 1.472-8(d) states, in part, that "(w)hether the number and the composition of the pools used by the taxpayer is appropriate, as well as computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool."

Treas. Reg. Sec. 1.472-8(e)(1) states, in part, that "(a) taxpayer may ordinarily use only the so-called 'double-extension' method for computing the base-year and current-year cost of a dollar-value inventory pool." This Regulation also provides that an index may be computed by double-extending a representative portion of the inventory pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. Sec. 1.472-8(e)(2) prescribes the operating rules for the use of the double-extension method. Under the double-extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second gives the amount of such inventory in terms of current-year cost.

Treas. Reg. Sec. 1.472-8(e)(2)(ii) states that the taxpayer is allowed to determine the current-year cost of items making up the pool by reference to (a) the actual cost of the goods most recently purchased during the year, (b) the actual cost of the goods purchased during the year in order of acquisition, (c) the average cost of the goods purchased during the year, or (d) any other proper method which clearly reflects income. The regulations also include examples as to how LIFO inventories should be computed under the double-extension method.

Where the use of the double-extension method is impractical, the taxpayer may use the index method or the link-chain method. There are no examples or other regulations that relate specifically to the use of the index or link-chain methods.

Even though the regulations do not provide specific rules for the link-chain or index methods, it is commonly agreed that those methods are conceptually comparable to the double-extension method. (See Schneider, Federal Income Taxation of Inventories, 1993 release page 14-86.) Except for the sampling techniques used in both the link-chain and the index methods and the use of a cumulative index in the link-chain method, the principles, concepts, and operating rules in the double-extension regulations are conceptually applicable to taxpayers on the index or link-chain methods.

The double-extension regulations are cited frequently to justify various methods and approaches used in conjunction with the link-chain method. For example, Treas. Reg. Sec. 1.472-8(e)(2)(iv), which describes the rules for determining layer increments and decrements, has been applied to the link-chain method. Another example is the application of Treas. Reg. 1.472-8(e)(2)(ii), which provides for the use of the earliest, latest, or average current cost to value LIFO layers, to link-chain taxpayers.

Thus, a taxpayer using the index or link-chain method may compute an index by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns.

## **DISCUSSION**

The regulations allow an index or link-chain taxpayer to develop an index by double-extending a "representative portion of the inventory in the pool or by the use of other sound and consistent statistical methods." The use of the word "other" in the regulations implies that the "representative portion" must be selected using sound and consistent statistical methods. Those methods require that every item in the population must have an equal non zero chance of selection. If some portion of the population has no chance of selection, defensible statistical projections cannot be made to that portion.

In Basse v. Commissioner, 10 T.C. 328 (1948), the Tax Court did not allow a taxpayer to apply an index, computed without reference to a material segment of inventory, to the total inventory. Basse was a retailer using the LIFO method of valuing inventory.

Basse had a pool containing inventory at both a warehouse and a number of stores. The goods located at the warehouse were the same as the goods at the stores, but in a different ratio or mix. Basse double-extended 100 percent of the warehouse goods in order to determine an index of inflation for the year. None of the goods located at the stores were double-extended. Basse divided the end-of-year costs at the stores by the warehouse index in order to determine the beginning-of-year costs for the stores.

The Service challenged the application of Basse's warehouse index to goods located at the stores on the grounds that the flow of goods at the warehouse was different from the flow of goods at the stores, and the application of the warehouse index to the goods at the various stores would not clearly reflect income. The court agreed with the Service on this point, holding that Basse could not use the warehouse index to compute the beginning-of-year costs of the stores' inventories. Many taxpayers have situations similar to Basse in that they also do not double-extend a representative portion of the inventory when they compute the index for their pools.

The Tax Court based its decision in Basse on the fact that the evidence of record disclosed that the taxpayer failed to prove that the warehouse index applied to goods located at the stores. Taxpayers may claim that they "considered" all segments of inventory when they computed the pool index. The regulations, however, require more than consideration. They require double-extension. The taxpayer must offer proof that the computed index is appropriate for the entire inventory. Failure to prove this will, as the court ruled in Basse, prevent the application of the indexes to the inventory not double-extended.

The taxpayer clearly has the burden of proving its LIFO index. Treasury Regulations, which are legislative regulations, place the burden of proof directly upon the taxpayer: "The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns." Treas Reg. Sec. 1.472-8(e)(1). The Supreme Court, in Commissioner v. Houston, 283 U.S. 223, 228 (1931), stated "The impossibility of proving a material fact upon which the right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof."

If the taxpayer is unable to substantiate the accuracy, reliability and suitability of the LIFO index for a segment of its inventory, then the district director has the authority to hold that the base-year cost of that inventory is equal to the current-year cost. The district director could assume no inflation (or other assumptions that protect the Government's interest) for that segment of inventory until the taxpayer meets its burden of proof.

**CONCLUSION**

The LIFO index cannot be applied to a segment of inventory which was not represented when the index was computed unless the taxpayer can demonstrate that the index is representative of the price movements of such segment (and clearly reflects income).